GOLD & ENERGY ADVISOR

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"The Month of September: It's the End of the Government's Fiscal Year, and the Beginning of 12 More Months of Government Lies!"

"Our nation's finances are in serious trouble. Here's what you aren't being told, and how it affects your investments!"

James DiGeorgia, Editor

- **A crime by any other name...**
- **U.N. helpless as Iran inaugurates nuclear reactor**
- **Is the real estate bubble bursting?**

A few months ago, a certain company announced its financial performance for the previous year: a dismal $318 million loss.

The CEO said he wasn't happy with the figures, but promised that plans were in place to turn the company around. He warned that it would take several years for the company to become profitable, but he was upbeat about the future.

Unfortunately, it was all a lie.

The company was carefully hiding an ugly truth from the public. As it turned out, the firm actually kept two sets of books.

One set had the numbers that were announced to shareholders and lenders. (*Especially* the lenders.)

The other set had the *real* numbers. These numbers said the company had been completely bankrupt for years, and was surviving only because the lenders hadn't caught on yet, and kept loaning the company more money. According to the real numbers, the company hadn't lost only $318 million. The true number was more than twice that—$760 million.

Insiders knew that the company was grotesquely bloated and inefficient, with enormous overhead. Much of its money was completely squandered. For example, company executives wasted huge amounts on personal luxuries for themselves.

But all this was carefully hidden from the public. The executives knew that if their gross mismanagement was revealed, the lenders would refuse to loan anything more to the company. And this lending (some $2 million each day) was required to pay daily expenses. It was the only thing keeping the doors open and the lights on. So the lenders, along with the rest of the public, had to be deceived.

THE GOLD AND ENERGY ADVISOR

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Obviously, this deception was more than enough for the CEO and all the Board members to be dragged off in handcuffs. But the company was engaged in an even more egregious fraud than this.

This company was in an industry with very complicated products and a long sales cycle. Orders are placed several years in advance of taking delivery.

At the time of its recent announcement, the company had been cheating its customers for years. The company had been taking orders, and receiving payment immediately. But it *wasn't building the products*. Customers were assured that production was right on schedule, and everything would be fine. But it was all a lie.

Every day, the company accepted more orders for future delivery. And every day, the company spent the money immediately, while making no provision for the actual delivery of the products later.

Obviously, with each new order the company incurred a future obligation. At the time of the recent announcement, the company had accumulated some $66 *billion* in future obligations. And every cent of the money that was provided to fulfill those obligations had been squandered.

This was a looming disaster of staggering magnitude. Clearly the company was about to implode. As soon as it defaulted on the first delivery, and the truth came out about what the executives had been doing, the entire company would collapse overnight. In fact, a disaster of this size would probably take down the entire stock market with it.

So why hadn't its investors stampeded for the exits a long time ago? It's simple. The executives knew very well what would happen once the truth came out, so they falsified their accounting even beyond the two sets of books.

All the customers' payments were booked as income, but the obligations for future deliveries weren't entered on the balance sheet. Interestingly, this made even the secret "second" set of books inaccurate. When the new future obligations were included—which is required under standard accounting—the company had actually lost far more than the $760 million last year. The true number was a jaw-dropping $3.5 *billion.*

Despite all this, the executives had still managed to trick the stock market into thinking that all was well. In fact, their flim-flam was so effective that the company's stock price remained high. It was actually considered the best investment in its sector.

At the time of the recent announcement, the whole house of cards was about to collapse. When the CEO made his promises for a future turnaround, the first of the company's backlogged orders were scheduled for delivery just a few months later. Of course, he knew that disaster was imminent, but he didn't seem to care.

In fact, *all* the executives knew that the truth was about to come out. Nevertheless, they seemed to think that if they continued to lie about it, this could somehow avoid the inevitable catastrophe.

Now I have to interrupt the story and ask you a question:

Would you want to own stock in this company at this point in its history?

No? Well, I have news for you.

You do.

First of all, as you might have guessed, this story isn't about any specific corporation. It's actually about Uncle Sam.

The company in my story represents our government. The executives are the politicians in Washington. The multiple sets of books are how our national finances are managed. And the shares of company stock are the dollars in your pocket.

Unfortunately, this story is actually *less* ugly than our real-life situation today. The numbers I used are one thousand times less than those on our nation's financial 'books'.

For fiscal year 2005, our official deficit was $318 billion. That's the first set of books I mentioned in my story. Even this "good" number is a national disaster (it works out to $871 million in new debt every single day).

However, our true deficit was far worse: $760 billion. That's $2.08 billion per day… which is $86.75 million per hour… which is $1.45 million *every minute*. Every 60 seconds we plunge further into debt by that amount.

As in the illustration, our government is helplessly dependent on new lending to stay afloat. $2 billion in new loans has to come in every day to pay all the bills. (And as in my story, many of these "bills" are outrageous and completely unnecessary, like Bridges to Nowhere and other disgusting pork-barrel projects. I think the "personal luxuries" in the story are a good analogy.)

Two billion dollars further in debt every single day. Those are horrifying numbers—but *still* not the full truth.

In my story, I told how the company accepted payments from customers, and booked them as immediate income to make the finances look good, but refused to acknowledge the later obligations. In real life, that's exactly what our government is doing with future Medicare and Social Security obligations.

Our government is collecting "extra" money for future benefit obligations, but spending it immediately instead of saving it, in order to cover up their gross mismanagement. But the future obligations aren't being recorded or published.

When you include future obligations in our government's books, our national deficit in 2005 alone was some $3.5 *trillion*. Overall our debt has grown to an incomprehensible $66 trillion. That's $227,500 for every man, woman, and child in this country, including you and me.

This means that if you have a family of four, you owe almost a million dollars. How does that make you feel? When's the last time you heard your local Congressman or Senator admit that he or she has put you into this debt?

Recently, we've seen crooked executives from Enron and other corporations bundled off into prison for breaking financial laws and deceiving shareholders. And rightfully so. But the same politicians who passed these laws are doing the same crooked things themselves, but on a *far* more egregious scale.

The hypocrisy here just amazes me. The government throws people into prison every year for financial crimes that are penny-ante compared

Latest prices as GEA goes to press— September 13, 2006

Comex spot contract: silver $11.17, gold $589.15
Nymex spot platinum: $1185, palladium $314
Nymex Light Sweet Crude Oil $64.24

Silver coins			Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles			$1,100	$1,180
100 1 oz. common rounds			$1,000	$1,150
$1,000 face value US pre-1965 coin bag (circulated)			$7,600	$8,100
$1,000 face value US circulated silver dollar bag (VG or better)			$10,500	$13,500
US Morgan silver dollars	PCGS	MS64	$45	$65
	PCGS	MS65	$110	$140
	PCGS	MS66	$280	$375
Platinum coins				
U.S. Platinum Eagle:		1 oz.	$1,158	$1,280
		1/2 oz.	$560	$670
		1/4 oz.	$280	$355
		1/10 oz.	$108	$160
Gold coins				
Australian Kangaroo			$580	$630
British sovereign (Kings)			$120	$158
(Elizabeths)			$120	$158
Canadian Maple Leaf			$580	$610
Credit Suisse 1 oz. gold bar			$580	$610
Mexican 50 peso Centenario			$680	$750
South African Krugerrand			$575	$615
US Gold Eagle:		1 oz.	$589	$620
		1/2 oz.	$285	$325
		1/4 oz.	$140	$168
		1/10 oz.	$50	$68
US $20 double eagle:				
Liberty	Raw	MS60	$600	$775
	NGC	MS63	$800	$1,200
	NGC	MS64	$1,800	$1,950
	NGC	MS65	$4,150	$5,950
Saint Gaudens	Raw	MS60	$625	$725
	NGC	MS63	$800	$900
	NGC	MS64	$1,000	$1,100
	NGC	MS65	$1,100	$1,450

Prices courtesy of Universal Coin & Bullion
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to the government's own lies and deceit. But nobody is saying a word about those.

When Will the House of Cards Collapse?

Our government's Social Security and Medicare obligations are about to become due and payable. The Baby Boomers will start to retire in the next couple of years, and will start collecting their so-called benefits. So the first of our 'scheduled deliveries' are almost upon us.

Notice though that this is where my analogy breaks down.

A company that committed the massive fraud in my story would be unable to fulfill its obligations, so it would collapse and disappear. Imagine though what would happen if the company could just print more of its shares, at will, and pay off its debts with them.

The shares would plunge in value, but as long as the company owned some assets, the shares would theoretically always be worth *something* (since each share represents a fraction, however small, of those assets).

So the company would keep printing more, and more, and more shares to pay its bills. Why not? Except for the cost of printing, it would be "free money."

Obviously, as each new batch of shares was printed, existing shares would be diluted. Their collective value would plummet, and the stock price would go into continual freefall.

Each successive batch of shares would have to be bigger than the previous one, if there was to be enough 'value' in them to be useful. Nevertheless, the printing would continue, in an endless downward cycle.

Of course, no company could do such a thing. But our government *can* do this—and it does.

As our "scheduled deliveries" for Medicare and Social Security become due, we're going to see a massive inflation of the dollar. Green paper will be flying off the presses at the Mint.

Dollar-owners will take huge losses and dump their holdings. Lenders will be increasingly reluctant to lend to us. Both of these will drive the dollar down even further.

The dollar is going to fall to its intrinsic value. Which, for a piece of paper, isn't much.

Oops, wait a minute—I forgot. Most dollars nowadays are electronic, not physical. But how much is an electron worth?

When you figure that one out, you'll have a good idea of where the dollar's value is headed.

That's Why I've Been Pounding the Table About Gold!

When you see disaster looming for a particular company, shorting its stock can be outrageously profitable. As the stock plunges, you make a killing.

Unfortunately, you can't do this with the dollar, even though our government seems determined to turn it into toilet paper. (Yes, you *can* short the dollar directly on the currency markets, but those markets are for gamblers rather than investors.)

Fortunately for us, gold is an alternative way to short the dollar. In fact, this is a better investment than a direct short could ever be anyway, because it can go up even if the dollar itself doesn't fall significantly.

As a tangible asset with intrinsic value, gold is a refuge when other investments plunge, or when political trouble breaks out around the world. In our current environment, that's reason enough to own gold.

But there's more to the story than just that...

Even in its role as a commodity, gold is looking great right now.

Last issue, I explained why gold profits handsomely when commodities overall are booming. I also told you why commodities are in a bull market right now, and why the bull should continue.

I didn't have room last month for all I wanted to say on this topic, so now I'll add to that discussion with…

Yet Another Reason the Commodity Boom Will Continue

Unless you're in the mining industry, you've probably never heard of BHP Billiton. But it's a gargantuan mining company—the largest in the world, producing not only gold but also silver, aluminum, iron ore, copper, nickel, and more. Its market capitalization is bigger than Coca Cola's.

BHP Billiton is leading the way in a new trend among miners. In the past, commodity producers generally wanted to produce as much as possible. Whenever commodity prices moved up, making producers more profitable, they would spend all the extra money on increasing production. Problem is, since all the producers did this, the market would become glutted with new supply, and prices would come back down.

Lately, this isn't the case. New management teams are in place at many commodity producers—executives with backgrounds in investment banking instead of prospecting or production.

With the current boom in gold and other commodities, producers are making money hand over fist. However, only some of that money is going back into increasing production. The rest is being used to buy back shares, or pay off debt, or pay dividends, or even to acquire other mining companies.

For example, BHP Billiton has announced plans to buy back $2 billion of its shares, and has raised its dividend by 30 percent. Rio Tinto PLC, the world's second-largest miner by capitalization, has announced it will spend $4 billion in share buybacks and dividends. Goldcorp just announced its plan to acquire Glamis Gold, which would create one of the world's largest gold-mining companies.

All of these activities drive up the company's stock price, increasing shareholder value—but *none* of them increase the world's supply of gold or other commodities. (Rio Tinto hasn't developed a new copper mine in over a decade, even though the price of copper has quadrupled in the last five years!)

In addition, miners today are using more sophisticated risk-analysis tools to assess future projects. As the *Wall Street Journal* recently described, only the most promising projects are being approved. Management vetoes all the rest.

As an example, the article quoted BHP Billiton's CEO (who incidentally is a banker, not a miner). He said, "My job is to make money, and sometimes that means steering clear of hot prospects that pose big risks."

This practice makes the company's financial performance more predictable. But this also decreases the amount of gold and other commodities that will come to market long-term, since the more speculative, "potential bonanza" deposits are being rejected.

All of this combined means that this commodity boom promises to be even more pronounced than past bull markets. And *that* means that gold is looking more promising than ever!

We've seen gold's price go sideways this summer. I continue to believe that $1,000 gold is not far away, and that this is just a consolidation phase before its next blast upwards. It promises to be a thrilling ride!

Portfolio Updates

In Update #232, we made recommendations for subscribers who own Atwood Oceanics (ATW) and Ensco International (ESV).

We sold the September $42.50 ATW calls (symbol ATWIV). This reduced our cost basis in the stock to about $40.60.

We also sold the September $45.00 ESV calls (symbol ESVII). This reduced our cost basis in the stock to about $45.02.

In Update #236, we made recommendations for subscribers own the short-term Anadarko Petroleum position.

We hedged this position by writing the $45 October calls (symbol APCJI). This brought our cost basis in the stock down to approximately $45.85.

Is the Housing Bubble Bursting?

In past issues, I've written about the dangers of our real estate bubble. If it bursts hard, it could wreak havoc across the entire economy. Now that housing sales are turning around and falling in many markets, even the mainstream media are (finally) starting to wake up to this danger.

The *Wall Street Journal* just ran an article that wondered if we've been too complacent about real estate prices. It quoted Mark Zandi, the chief US economist at Moody's Economy.com. He said, "We could be underestimating the dark side… Euphoria could turn into abject pessimism very quickly."

The article continued with this: "When housing took a similar turn in the 1970s, new-home sales quickly fell to their long-term norm. This time around, that would entail about a 50% decline in sales, says Ian Shepherdson, chief U.S. economist at consulting firm High Frequency Economics… 'It's a 15-year bubble unwinding in two years. It's going to hurt.'"

Other commentators believe the bust is already here. There's plenty of bad news to back them up.

For example, California announced that mortgage defaults in the second quarter increased by 67% from last year. If this is the beginning of a broader trend, then we'll see real estate prices crashing all around us.

In a sense, a wave of defaults was almost inevitable. The housing boom of the last 14 years was only partially driven by real estate becoming more valuable. For the most part, it was driven by loose financing: money available for borrowing at incredibly cheap rates. Now that cheap money has dried up, that driving force is gone.

The scary part is the popularity of "innovative" lending programs in the last couple of years. Real estate valuations are so over-inflated that people couldn't afford mortgages even in a time of historically low interest rates.

So the last couple of years have seen a huge expansion in "creative" ways to finance homes.

ARMs (adjustable-rate mortgages) have been especially popular around the country. People have gotten into homes at far below market interest rates. Of course, after the initial period is over, the interest rates adjust to market conditions. (Usually *above* the average market rates, actually.)

These things were ticking financial bombs, waiting to go off. Now the ARMs are starting to adjust, and homeowners are waking up to the horrible traps they've set for themselves.

The *Wall Street Journal* recently wrote about some homeowners who are seeing their mortgage payments go up by 25 or 30 percent. One accountant interviewed in the article had paid $312,000 for her house, with an ARM at 2.3%. Now her rate has shot up to 8.75%, and her mortgage balance has actually gone *up* (to $324,000) instead of down. And she can't refinance, thanks to a nasty prepayment penalty.

Yes, it's her own fault for accepting such a mortgage. But she says she didn't understand all the terms of the agreement.

Now this is interesting. If an *accountant* can't understand how these things work, how much chance will Joe Public have?

Not much, apparently. That's why, according to Credit Suisse, the percentage of ARMs that are at least 90 days past due has shot up by 140% this year.

And this is just the beginning of a broad wave of adjustments. According to UBS, $137.5 billion in ARMs will be adjusted this year. Over the next five years, the number is $524 billion.

Nationwide, there are alarming signs in real estate. For example, sales of "existing" (not new) homes dropped 11.2 percent since this time last year. And there are 3.86 million existing homes on the market—a record number, up a whopping 39 percent since last year. At the current sales rate, it will take 7.3 months to sell these homes—which is several months higher than the average number during the recent boom.

Home buyers have become very scarce. The Mortgage Bankers Association says that

Iran Defies U.N. and Opens New Nuclear Reactor; Russia Rejects Sanctions.

Last month, Iran inaugurated a new heavy-water production plant. ("Heavy water" contains a heavier hydrogen atom.) This was in defiance of continued U.N. demands to stop activities that could be used to make nuclear weapons.

Spent fuel from a heavy-water reactor can be processed to make plutonium, which in turn can be made into nuclear bombs.

Note that Iran could have chosen a light-water reactor, which doesn't produce any byproducts that can be used in bombs. But they decided to build a heavy-water plant instead. (Hmm—I wonder why.)

Meanwhile, Russia has rejected the notion of U.N. sanctions against Iran. Russian Defense Minister Sergei Ivanov said Iran's race for nuclear weapons is "not so serious" of an issue.

As a member of the Security Council, Russia can veto and therefore block any actions taken by the Council. So Russia's opposition to sanctions effectively kills the whole idea, leaving the U.N. officially powerless to stop Iran.

Not that the U.N. would actually have done anything, but at least there would have been "official" endorsement of what the United States is eventually going to do anyway: a military intervention.

The mullahs have grown increasingly bold as late. Their pet Hezbollah terrorists in Lebanon just survived a war with Israel (a war in which *Iranian* fighters were identified as participating, by the way).

Meanwhile, the United States is wearing out its military in the continued quagmire in Iraq (where Iran is also supporting the forces we're fighting against). The mullahs figure that even if we did want to intervene in Iran, we wouldn't have the capability right now.

Overall, Iran's status in the militant Islamic world has been greatly enhanced lately. So it's not surprising that they've become increasingly bold and belligerent about their nuclear program.

Bold enough to build nukes? Apparently so. Insane enough to use them against Israel, and start a broader war? We'll see…

applications for home-purchase mortgages have plummeted 20 percent since this time last year.

New-home sales have taken a hit too, falling 12 percent so far this year. Home-building companies are getting whacked as a result.

For example, luxury-home builder Toll Brothers Inc. reported a third-quarter drop in profits of 19 percent. Earlier this year, an industry survey said that 31 percent of builders were paying closing fees for buyers. Fifteen percent were helping with financing in one way or another. No wonder that an industry index of builder confidence has plunged to its lowest point since 1991.

In California, brokers are even reporting the return of "short sales." These are home sales where the price isn't enough to cover the debt owed on the house by the previous owner. The homeowners have to pay cash out of pocket just to sell their houses.

In some cases, the banks are even being forced to eat the losses instead—the homeowners can't afford to pay the differential, and the bank either pays the difference or forecloses on the house (taking an even bigger loss).

MSN ran an article ("When homeowners are desperate to sell") about how quickly the housing market turned around. Just a year ago, houses were flying off the market, often at more than the asking price. Now sellers can't seem to give them away.

One person in the article had listed her house for $480,000. She's since lowered it to $427,000, and has even given away football tickets and a free day at the spa to attract buyers to her open houses. But nobody's bought.

Another person bought a house at $615,000 a year ago, and just sold it for $440,000.

Brokers across the country are dangling gifts in front of buyers: vacations, gasoline cards, paydown of points, help with down payments, even a mortgage payment or two.

One agent in Florida actually offered a Mercedes Benz with the house sale!

For me, the real stunner in all this was a short statement from the chief economist of the National Association of Realtors. First of all, he predicted a decline in U.S. home prices. Then he actually said he was hoping for prices to drop, so buyers would be lured back into the market.

What?

Somebody from the Realtors Association—the group of people who continually preach that "real estate is the best possible investment, it always goes up in the long term, go find a Realtor and buy a house today"—not only predicted lower prices, but is *hoping* for them?

This is like the chairman of Coca-Cola saying that people shouldn't drink soft drinks anymore, because sugar water will make your teeth rot and fall out of your skull.

All this combined is very disturbing news. A steep fall in real estate prices will mean a wave of mortgage defaults, and serious trouble in the credit derivative markets (which have ballooned from $4 trillion up to a staggering $17 trillion in just three years).

This might start the whole global chain of cascading cross-defaults that Alan Greenspan was so worried about during his tenure as head bubblemeister at the Fed—where all financial markets (stock, bond, currency, etc.) would be taken down at once.

If nothing else, a real estate crash will destroy people's equity in their homes. This business of using your home as an ATM (pulling money out and spending it) will come to a screeching halt, and consumer spending will fall like a stone.

Unfortunately, as I've discussed in past issues, consumer spending is over 60% of the U.S. economy. If it goes away, then lots of other things in our economy go away too (jobs, economic growth, low inflation rates, etc.)

So what can we do about it? Simple. First of all, avoid speculative real estate investments, and avoid mortgage-backed securities.

Second, make sure you're invested in gold!

Here again, the yellow metal is a solid way to protect yourself. Gold flourishes in chaotic, crashing markets.

We could wish that we weren't at risk of these today, but wishing won't change anything.

Far better to recognize reality for what it is, and prepare for it!